91-43 (1)

Supreme Court, U.S.
FILED
JUL 5 1991
OFFICE OF THE CLERK

No.

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1990

DAVID COOK,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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## QUESTION PRESENTED

Is a commodities dealer entitled to deduct commodities straddle trading losses under section 108 of the Deficit Reduction Act of 1984, as amended by section 1808(d) of the Tax Reform Act of 1986, when the commodities dealer's straddle transactions, which actually occurred, have been characterized as lacking economic substance?

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The petitioner, David Cook ("Cook"), respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit"), entered in the above-entitled proceeding on April 22, 1991.

## OPINIONS BELOW

The opinion of the Ninth Circuit has not been reported. It is reprinted in the Appendix. The opinion of the United States Tax Court ("Tax Court") is reported at 90 T.C. 975 (1988), and is also reprinted in the Appendix.

## JURISDICTION

Judgment was entered by the Ninth Circuit on April 22, 1991. No petition for rehearing has been filed by petitioner and no extension of time within which to file the petition for a writ of certiorari has been sought. The jurisdiction of this Court to review the judgment of the Ninth Circuit is invoked under 28 U.S.C. § 1254(1).

## CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS INVOLVED

This case involves section 108 of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, and the amendment thereto in section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817. These statutes are reprinted in the Appendix.

## STATEMENT OF THE CASE

### A. Facts

The great preponderance of facts in this case are stated at length in the Tax Court's decision in *Glass v. Commissioner*, 87 T.C. 1087 (1986), and *Cook v. Commissioner*, 90 T.C. 975 (1988). The jurisdiction of the Tax Court in these cases was authorized by 26 U.S.C. 6213(a), 6214 and 7442.[1]

During all of 1976 and 1977, Cook was a commodities dealer within the meaning of section 1402(i)(2)(B) of the Code. During those years, he entered into certain silver and copper commodity futures contracts on the London Metal Exchange ("LME"). Cook reported losses from these transactions on his 1976 and 1977 federal income tax returns. For purposes of this case, the parties have stipulated that the transactions in question have been sufficiently authenticated but that they lacked economic substance, *i.e.*, Cook's transactions were motivated primarily by tax savings.

### B. Proceedings and Disposition in the Tax Court

On November 16, 1981, the Commissioner of Internal Revenue ("Commissioner") issued to Cook a statutory notice of deficiency ("the notice") in accordance with section 6212(a) of the Code, asserting deficiencies in Cook's income tax for the years ending December 31, 1976, and December 31, 1977, in the amounts of $862,188.00 and $135,108.00, respectively. Although the notice listed five different types of adjustments to Cook's taxable income, substantially all of the deficiencies asserted in the notice were attributable to the disallowance of capital losses in the amounts of $1,250,022.80 and

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[1] 26 U.S.C. contains the Internal Revenue Code ("Code"). All references herein to Code sections are references to sections of 26 U.S.C.

$217,782.00 reported by Cook in connection with his commodity straddle trading activities on the LME.

Cook timely filed a petition with the Tax Court in which he contended that the Commissioner had erred in disallowing his commodity straddle trading losses. At the time Cook's Tax Court petition was filed, his position was thought by the Tax Court to be substantially the same as that of approximately fourteen hundred other petitioners who had conducted trades on the LME, and his case was consolidated with theirs. Trial of these cases was held under the name *Glass v. Commissioner*, and the Tax Court's opinion, holding that none of the petitioners was entitled to the commodities trading losses claimed from their respective dealings on the LME, is found at 87 T.C. 1087 (1986).

During the course of the trial in *Glass*, Congress enacted the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984) ("DEFRA"). Section 108(a) of DEFRA provided in general that certain losses from the disposition of one leg of a commodity straddle entered into prior to 1982 were deductible if the straddle was entered into for profit. Section 108(b) of DEFRA provided in general that straddle transactions of commodities dealers were rebuttably presumed to be entered into for profit.

Subsequently, section 108 of DEFRA was amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) ("TRA-86"). Amended section 108 of DEFRA (unless otherwise stated, all references hereinafter to "section 108" shall mean section 108 of DEFRA, as amended by section 1808(d) of TRA-86) provides, among other things, that losses attributable to the disposition of a leg of a straddle which were incurred in a trade or business before 1982 are deductible, and that losses arising from the disposition of a straddle leg which were incurred by commodities dealers, as defined in section 1402(i)(2)(B) of the Code, are deemed *per se* to be incurred in a trade or business.

The Tax Court's opinion in *Glass* held that no petitioner was entitled to recognize the commodity trading losses in issue because the transactions in which they were incurred lacked economic substance. Although the Tax Court noted that "amended section 108 . . . makes it clear that losses incurred by commodities dealers trading in

commodities are deductible under section 108 since they are losses incurred in a trade or business," [87 T.C. at 1167] the Tax Court did not pursue this avenue because it understood that "the case before us does not involve commodities dealers." [87 T.C. at 1167].

In *King v. Commissioner,* 87 T.C. 1213 (1986), decided after *Glass,* the Tax Court held that an individual commodities dealer who entered into straddle transactions prior to 1982 was entitled to recognize his losses under section 108 without regard to whether the transactions had economic substance.

Following the decision in the *King* case, Cook filed a motion for leave to amend his Tax Court petition to assert that during 1976 and 1977 he was a commodities dealer within the meaning of section 1402(i)(2)(B) of the Code, and he also filed a motion for reconsideration of the findings and opinion in the *Glass* case, as it applied to him.

By Order dated July 22, 1987, Cook's motion for leave to amend his petition was granted and his amended petition was accepted as filed. In his answer to the amended petition, the Commissioner admitted that Cook was a commodities dealer as he claimed. At a motions session of the Tax Court on September 30, 1987, Cook's case was severed from the consolidated *Glass* cases, and the Tax Court directed the parties to file briefs on the application of section 108 to dealers.

The parties agreed that the issue in the case was:

> Whether the per se presumption applicable to the losses of a dealer under section 108 of the Deficit Reduction Act of 1984, as amended by section 1808(d) of the Tax Reform Act of 1986, is applicable to losses claimed with respect to straddle transactions undertaken on a foreign exchange not regulated by a United States entity or to straddle transactions which the Court has previously determined "lacked economic substance and w[ere] a sham."

The parties were directed by the Tax Court to make the same assumption for purposes of argument as the Tax Court made in *Glass*; namely, that the commodity contracts which Cook entered into were actual contracts. *Glass*, 87 T.C. at 1172. Thus, just as in *Glass,* the Tax Court was to focus its attention not on whether Cook had sufficiently authenticated his transactions (*i.e.*, proved that there *were* actual

transactions), but rather whether such transactions, assuming they were proven to have occurred, fell within the ambit of the *per se* rule of section 108.

In *Cook v. Commissioner*, 90 T.C. 975 (1988), the Tax Court, in an opinion in which 14 other Judges joined the author, Judge Nims, held that section 108 was inapplicable because Cook's transactions were "prearranged" and lacked economic substance and therefore were not entitled to the benefits of section 108. There were two concurring opinions. The first, authored by Judge Whitaker, and subscribed to by two Judges, declined to agree with the majority opinion because it "simply writes section 108 off the books", as Cook had argued, but agreed with the result reached by the majority on the grounds that section 108 was not intended to apply to trades on a foreign exchange, an alterative argument advanced by the Commissioner which was not considered in the majority opinion. In a second concurring opinion, authored by Judge Wells, nine Judges, each of whom also had joined in the majority opinion, agreed that they would hold for the Commissioner on both the grounds stated in the majority opinion and the grounds stated in the first concurring opinion. Two Judges did not participate in the case.

Following the Tax Court's decision in *Cook*, the Ninth Circuit affirmed *Glass, sub nom. Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989).

### C. Proceedings and Disposition in the Ninth Circuit Court of Appeals

Cook appealed the decision of the Tax Court in this case to the Ninth Circuit. In his brief, Cook argued that he was entitled to the benefits of the *per se* rule of section 108 and that this rule was applicable notwithstanding the fact that his trades occurred on a foreign exchange. Oral argument was held on April 18, 1990, and on April 22, 1991, the Court issued an unpublished memorandum opinion affirming the Tax Court's opinion that section 108 was not applicable because Cook's commodity trades lacked economic substance. The Court did not reach the question of whether section 108 was applicable to trades on foreign exchanges. On May 6, 1991, the United States Department of Justice filed a motion with the Ninth Circuit requesting

publication of its opinion. A copy of the motion is attached as part of the Appendix.

## REASONS FOR GRANTING THE WRIT

In *Cook v. Commissioner*, the Ninth Circuit decided an issue that involves an important federal income taxation question. This issue is of sufficient importance to deserve Supreme Court review because of the number of similarly pending actions in the federal courts, the aggregate amount of federal tax revenue that is in issue, and the incorrect nature of the decision of the Ninth Circuit.

In its motion for publication of the Ninth Circuit's opinion in this case, the Department of Justice stated that the issue presented in this case is of continuing administrative importance to the Government. In support of its motion, the government stated that the identical issue is now pending in three consolidated cases before the Third Circuit, and eight cases pending before the Second Circuit. Additionally, the Government stated that it had been informed by the Internal Revenue Service that there are at least 4,282 cases pending before the Tax Court in which the Commissioner is urging that the straddle transactions at issue lacked economic substance. Of the 4,282 cases, the Service has estimated that as many as ten percent of those cases present the issue decided by the Ninth Circuit in the *Cook* case. Further, venue for appeals from these cases is likely to lie in every circuit court of appeals.

The number of the above-mentioned cases that already are pending in the federal circuit courts of appeals and the Tax Court evidence the continuing importance of the issue in this case. On prior occasions, a sufficient reason for the Supreme Court to grant a petition for writ of certiorari has been the number of pending cases which involve a similar issue and/or the number of potential litigants which might bring a similar action. *See United States v. Powell*, 330 U.S. 238, 240 (1947) (certiorari granted "because of the importance of determining the controlling principle for settlement of the many claims of this character against the government"); *United States v. Standard Oil Co.*, 332 U.S. 301, 302 (1947) (certiorari granted "because of the novelty and importance of the principal question," defined in a footnote by reference to the number of potential actions and suits already commenced); *Laing v. United States*, 423 U.S. 161, 167 (1976)

(certiorari granted because 70 pending cases in the federal courts depended on resolution of conflict among the circuits with respect to tax matter); *FTC v. Jantzen*, 386 U.S. 228, 229 (1967) (certiorari granted "in view of the pendency of almost 400 such orders and the conflict among the circuits").

While there currently is no conflict among the circuit courts relating to the issue in this case, there clearly exists the potential of a future conflict. In *Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989), affirming *Glass v. Commissioner*, 87 T.C. 1087 (1986), a case involving an investor, not a dealer, the Ninth Circuit held that section 108 was inapplicable to transactions having no economic substance. 865 F.2d at 1092. In effect, the Ninth Circuit held that the Court need not consider whether the taxpayer investor's transactions were entered into for profit, as section 108 requires, because when the investor's transactions are described as economic shams, section 108 does not apply *ab initio*. Further analysis is not required. This approach was also taken in *Friedman v. Commissioner*, 869 F.2d 785, 791 (4th Cir. 1989), and *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989), two other decisions affirming *Glass*.

In two other *Glass* affirmances, the Court of Appeals found that the transactions in question could not satisfy the investor's profit motive test of section 108 but did not go so far as to say that section 108 was inapplicable in the first instance. *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988).

In *Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989), the Court agreed with the Tax Court's conclusion in *Glass* that the LME transactions lacked economic substance, but nonetheless went on to consider whether the transactions met the profit motive test of section 108. While, as one might expect, the Court found that the profit motive test had not been satisfied, the significance of *Killingsworth* is that the Court did not conclude that section 108 was not applicable in the first place.

The only *Glass* affirmance in which the different approaches to the section 108 problem raised by *Glass* were articulated is *DeWees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989), in which the Court concluded that there was no compelling reason to find that an

economic sham transaction automatically lay outside the purview of section 108.

> And, one need not view the "sham in substance" doctrine as *always* taking a transaction entirely outside its statutory framework. One could view it more simply and more generally as an interpretive tool that helps courts read tax statutes in a way that makes their technical language conform more precisely with Congressional intent. Thus, one could view this type of "sham" transaction as a special subset of transactions not "entered into for profit" within the meaning of §108. The conceptual virtues of doing so are: (1) permitting §108(c) to govern the treatment of other portions of the transactions; and (2) conforming to Congress' apparent object in writing §108, namely, to create a provision that would govern cases such as the one before us. Doing so interferes with no Congressional objective; it is not reasonable, given the history and language of §108, to believe that Congress, in enacting that provision, wished to weaken the "sham in substance" doctrine by mandating the consideration of subjective factors. This is to say, we need not accept the dilemma: 'Either (l) the "sham in substance" doctrine applies, *or* (2) §108 applies and "subjective motive" is relevant.' Rather, we see no conceptual difficulty in saying that *both* the "sham in substance" doctrine and §108 apply, the former doctrine defining a special subset of transactions that are not "entered into for profit" under the latter statute. Under this view, "sham" transactions would lie *inside,* not *outside,* the "plain intent of the statute." *Gregory,* 293 U.S. at 470. (Emphasis in original.)

870 F.2d at 35-36.

The Court did not specifically adopt this approach because, in *DeWees,* he being an investor without a profit motive, not a dealer,

> the question of whether the sham transaction falls inside, or outside, the statutory provision is only of metaphysical interest, and makes no practical difference.

870 F.2d at 36.

For David Cook, this question is anything but metaphysical for, if section 108 cannot apply *ab initio,* he has no chance of prevailing in this case whereas, if he falls within the ambit of section 108 in the first instance, he is unequivocally covered by the *per se* rule of section 108(b).

Clearly, the circuit courts of appeal are not of one mind as to whether section 108 can ever apply to a transaction lacking economic substance. Although their consideration of this issue has produced no conflict in result to date, their conflicting analyses of the threshold for the application of section 108 indicate that a conflict is more than likely to arise with respect to the hundreds of cases involving the dealer issue which inexorably are winding their way toward resolution in the circuit courts. In the interests of preserving judicial economy and efficiency, providing a uniform rule for thousands of interested litigants, and finally resolving a much disputed matter, the Supreme Court should grant the petitioner's motion for writ of certiorari in *Cook v. Commissioner.*

As a separate ground, the Court has previously held that the amount of money in controversy, particularly when the United States or a subdivision thereof is a party, can prove a sufficient reason to grant a petition for writ of certiorari. *See Alaska v. America Can Co.,* 58 U.S. 224, 225 (1959) (certiorari granted "in view of the fiscal importance of the question to Alaska," even though the statute had been repealed); *United States v. Mitchell,* 463 U.S. 206, 211 (1983) (certiorari granted "[b]ecause the decision of the Court of Claims raises issues of substantial importance concerning the liability of the United States"); *Commissioner v. Standard Life & Accident Ins. Co.,* 433 U.S. 148,151 (1977) (certiorari granted because of the presence of a conflict and "because the question is important to the revenue"). While there is a significant amount of money at issue in the *Cook* case, $997,296.00, the aggregate amount that the Internal Revenue Service currently has at stake with respect to the litigation of the same or a similar issue as appeared in *Cook* is many times this figure (it would be more than $4 billion if each of the above-mentioned straddle transaction cases pending in the federal courts involves approximately the amount at issue in *Cook).* As was the case in *Alaska v. American Can Co., United States v. Mitchell,* and *Commissioner v. Standard Life & Accident Ins. Co.,* the Court should grant this petition because of

the substantial monetary interest that the United States has in the final resolution of this issue.

Third, and equally important, the Supreme Court should grant certiorary because the Ninth Circuit has acted to nullify a federal statute.

In relevant part, section 108 reads as follows:

> **SEC. 108 Treatment of Certain Losses on Straddles Entered into Before Effective Date of Economic Recovery Tax Act of 1981.**
>
> (a) **General Rule.** – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions –
>
> (1) which were entered into before 1982 and form part of a straddle, . . .
>
> any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) **Loss Incurred In A Trade or Business.**– For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.
>
> (c) **Net Loss Allowed.** – If any loss with respect to a position described in paragraphs (l) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.
>
> . . .
>
> (f) **Commodities Dealer.** – For purposes of this section, the term "commodities dealer" means any taxpayer who –

> (1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), . . . .

The statutory scheme is simple enough — any loss recognized by a commodities dealer from disposing of a commodities straddle position entered into before 1982 is incurred in a trade or business and is therefore allowed for income tax purposes. David Cook is a commodities dealer; he disposed of a straddle position entered into before 1982; he incurred a loss. One would think the loss would be allowed. The Ninth Circuit, however, has concluded that no loss existed because David Cook's commodities transactions were primarily tax motivated. The Ninth Circuit founded its opinion squarely on *Gregory v. Helvering*, 293 U.S. 465 (1935).

> Since the straddle had no business purpose, and was purely an artifice to generate a tax benefit without any change in the taxpayer's economic position, *Gregory* prohibits any recognition of loss.

*Cook v. Commissioner*, (9th Cir. 1991), at page 3. (See Appendix.)

Reliance on *Gregory* overlooks the fact that Congress had a different result in mind when it enacted section 108. Note that, under this provision, a loss is allowed either if "such loss is incurred in a trade or business" or if "such loss is incurred in a transaction entered into for profit though not connected with a trade or business." The Ninth Circuit held that Cook incurred no loss because he did not trade commodities with a profit motive, but section 108 says nothing about profit motive where a trade or business is concerned — only where one is absent. To hold that the existence of a loss for a commodities dealer presupposes a profit motive is to ignore the plain language of section 108(b) which provides that "any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business" and to make section 108(a) read, in relevant part, as if it said

> (a) **General Rule.** — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —

> (1) which were entered into before 1982 and form part of a straddle, . . .
>
> any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a *transaction entered into for profit* in a trade or business or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

The Ninth Circuit would deny this characterization by stating, as it did on pages 8 and 9 of its Memorandum Opinion, that:

> The words of the statute now precisely track the hoary formula of §165(c)(1) and §165(c)(2) of the Code:
>
> (c) LIMITATION OF LOSSES OF INDIVIDUALS. — In the case of an individual, the deduction under subsection (a) shall be limited to —
>
> (1) losses incurred in a trade or business;
>
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business . . .
>
> Internal Revenue Code, 26 U.S.C. §165 (1986). It is unlikely that Congress meant anything different by its use of these terms of art in §108 of the 1984 Act as amended by the 1986 Act, from what it has meant for many years in §165 of the Code. *Cf. Landreth v. Commissioner*, 859 F.2d 643, 648 (9th Cir. 1988) (after the 1986 amendments, "the 'entered into for profit' language in section 108 should be interpreted in the same way as the identical language in section 165(c)(2)."); *Miller v. Commissioner*, 836 F.2d 1274 (10th Cir. 1988); *accord Glass*, 87 T.C. at 1166. Tax recognition is generally denied to paper losses in transactions having no economic effect, whether they take place in a trade or business or not, without ever reaching the issue of subjective motive. *See Gregory v. Helvering*, 293 U.S. 465 (1935). *Once Congress amended 108 in 1986 to make the language track the traditional §165 language, it eliminated the need to construe §108 in a fashion distinct from §165. The structural parallelism of the sections gives us the meaning.* (Emphasis added.)

This defense, rather than justifying the Ninth Circuit's opinion, condemns it. If one paraphrases what the Ninth Circuit has said, its conclusion is that Congress is so inept that it enacted a piece of legislation, which it subsequently amended, just so it could have another statutory provision to say exactly what Congress had already provided years before. The Ninth Circuit calls this "structural parallelism." Any reasonable person would call it redundancy.

Certainly, Congress is not above enacting a redundant statute, but a co-equal branch of the federal government should make some effort to give the legislative branch the benefit of the doubt here. Maybe Congress actually thought it was accomplishing something. Certainly, at the time section 108 was enacted, many of its critics did. One need only consider Judge Simpson's dissenting opinion in *Miller v. Commissioner*, 84 T.C. 827, 854-856 (1985), a case, subsequently reversed [836 F.2d 1274 (10th Cir.1988)], in which the Tax Court extended section 108 to favor taxpayers other than dealers, to see what section 108 was thought to accomplish for dealers even before it was amended in 1986 to provide dealers with still more favorable treatment.

> Furthermore, if the majority's interpretation is adopted, the presumption contained in section 108(b), which was enacted to provide special relief to dealers in tax straddles, is unnecessary. In virtually every tax straddle, there will exist the possibility of a profit, and therefore, under the majority's interpretation, all traders in tax straddles will receive tax relief, thereby eliminating the need for a presumption in favor of dealers....
>
> Aside from the Statement of the Managers in the Conference Committee report, the managers of the legislation, Chairman Rostenkowski of the Ways and Means Committee and Senator Dole, Chairman of the Finance Committee, offered no further explanation of the scope or effect of section 108. However, Senator Howard Metzenbaum, of Ohio, spoke out about section 108:
>
> > the effect of that provision is virtually to preclude the IRS from pursuing tax cases against about 200 traders of commodity futures for an estimated $300 million

> in taxes that the IRS is trying to collect from traders who used the now outlawed tax avoidance scheme known as a commodity straddle.
>
> As a matter of fact, the IRS preliminary data indicates that there are 4,400 cases presently pending in [the] Tax Court representing $500 million in taxes before interest is assessed. The IRS has assessed deficiencies for 15,000 taxpayers for $1.5 billion. There is no data on how many professional traders are involved, but we do know that whether it is $300 million or $500 million or a substantial amount more, the commodity traders and dealers were well taken care of in the conference committee * * *
>
> [11 Cong. Rec. S8390 (daily ed. June 27, 1984).]

Similarly, Richard L. Ottinger, a Representative from New York, stated on July 24, 1984, that "This tax break [provided by section 108] has been afforded to 200 or so commodity traders in Chicago at a cost of $300 million to the Government" 12 Cong. Rec. E3251 (daily ed. July 24, 1984). Mr. Ottinger also inserted into the Congressional Record an article from the Washington Post of July 2, 1984, in which the author stated that:

> Rostenkowski's bailout means that two taxpayers who arranged virtually identical commodity deals to avoid paying taxes will be treated differently.
>
> Ordinary investors will have to show they were trying to make money, not simply create losses to claim as tax deductions. But thanks to Rostenkowski, "professional commodity traders and persons who regularly trade commodity futures contracts" will be presumed to have a profit motive.
>
> In many cases that distinction will mean the brokers who invented this tax dodge will get away with using it, but their clients will have to pay taxes.
>
> [12 Cong. Rec. E3251 (daily ed. July 24, 1984).]

> These statements by Senator Metzenbaum and Representative Ottinger do reflect the contemporaneous understanding of what Congress was doing by the enactment of section 108. Congress realized that it was extending substantial tax relief to dealers in tax straddles, but these statements make it indisputably clear that Congress had no understanding that it was granting tax relief to all traders in tax straddles with a consequent loss in revenue exceeding $1.5 billion. The outcry by the critics of the legislation would, no doubt, have been substantially greater had they understood that the legislation was extending tax relief to all traders of tax straddles.

One simply cannot square the contemporaneous perception of section 108's critics that it was intended to provide a tax break or bailout for commodities dealers with the Ninth Circuit's notion that section 108 has no purpose other than to restate old section 165(c), which would do nothing of the kind. Apart from Judge Simpson's analysis of this issue, three distinguished former officials of the United States Treasury Department[2] , in a presentation delivered to the 42d Annual Federal Tax Conference of the University of Chicago Law School in October of 1989, more than a year after the Tax Court's decision in *Cook*, stated

> Congress, in order to repair the damage [done by the decision of the Tax Court in *Miller*] subsequently enacted remedial legislation [the 1986 amendment to section 108] that perhaps, gave more aggregate relief to taxpayers than the original language would have done (*as it gave amnesty to everyone engaged in the commodities trading business*, many of whom would have failed the earlier test, while

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[2] Donald C. Lubick who was Tax Legislative Counsel of the Treasury Department during the Kennedy-Johnson administrations, 1961-1964, and returned as Deputy Assistant Secretary and then Assistant Secretary of the Treasury for Tax Policy during the Carter administration, 1977-1981. Frederick W. Hickman who was Assistant Secretary of the Treasury for Tax Policy during the Nixon-Ford administrations, 1972-1975. Bradford L. Ferguson who was Tax Legislative Assistant to Senator Walter Mondale, then a member of the Senate Finance Committee, 1975-1977. During the Carter administration, he was Special Assistant to the Assistant Secretary of the Treasury for Tax Policy, 1977-1979, and Associate Tax Legislative Counsel of the Treasury Department, 1979-1980.

> snaring all of the tax shelter taxpayers, almost all of whom would have been caught under the original language). [Emphasis added.]

*Re-examining the Nature and Role of Tax Legislative History in Light of the Changing Realities of the Process* by Lubick, Hickman and Ferguson, a paper delivered at the Forty-Second Annual Federal Tax Conference of the University of Chicago Law School. Reprinted in Taxes, the Tax Magazine, Dec. 1989, Vol. 67, No. 12, P. 814, Fn. 19.

Maybe Mr. Rostenkowski did not act in the national interest when he provided special tax breaks for his constituents with seats on the Chicago Mercantile Exchange but, under the United States Constitution, he had every right to do what he, and ultimately, Congress, did, and the Ninth Circuit's nullification of section 108 represents totally unacceptable judicial interference in the legislative process. Notwithstanding its protestations, by treating section 108 as nothing but a repetition of section 165(c) of the Code, the Ninth Circuit has written section 108 off as meaningless, just as Judge Whitaker claimed in his concurring opinion in Cook's Tax Court case.

To the extent the Supreme Court is concerned in this case with the application of *Gregory v. Helvering,* 293 U.S. 465 (1935), Cook's position is in no way inconsistent with the time-honored holding of that case. While, as a general rule, transactions which comply with the form prescribed by a tax provision, but which lack economic substance, may be disregarded by the Commissioner, Congress is also free to prescribe that transactions be given tax substance notwithstanding their lack of economic underpinnings. This conclusion is unequivocally mandated by the "Grandmother" of the economic substance cases, *Gregory v. Helvering, supra. See generally* Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters.* 5 Va. Tax Rev. 825 (1986) (hereinafter cited as "Gideon"). The taxpayer in *Gregory* was the sole shareholder of a corporation and wished to receive the proceeds from the sale of part of the corporation's assets. Solely for the purpose of avoiding the dividend treatment that would result if the assets to be sold were distributed to her, the taxpayer formed a second corporation and had the first corporation transfer the assets to be sold to the second corporation in a transaction that purportedly constituted a tax-free reorganization.

The second corporation was soon thereafter liquidated, and the taxpayer reported capital gain in connection with the liquidation.

The Supreme Court held that transfer of the assets to the newly formed corporation did not constitute a reorganization despite literal compliance with the reorganization provisions of the statute.

> The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

293 U.S. at 470.

*Gregory* thus stands for the general and widely accepted rule that transactions lacking economic substance may be disregarded for tax purposes. Under the *Gregory* doctrine, an actual transaction will be ignored for tax purposes if it was undertaken without any business or other non-tax purpose, but solely to secure tax benefits. *Accord, Frank Lyon Co. v. United States,* 435 U.S. 561, 583-84 (1978) (defining a "transaction with economic substance" as a transaction "which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached"); *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89, 92 (4th Cir. 1985) ("We agree that such a test properly gives effect to the mandate of the Court in Frank Lyon that a transaction cannot be treated as a sham unless the transaction is shaped solely by tax avoidance considerations.")

The quoted passage from *Gregory* makes absolutely clear, however, that a court's determination that a transaction lacking economic substance should be disregarded for tax purposes requires an inquiry into Congressional intent. As Mr. Gideon, former Chief Counsel of the Internal Revenue Service, and current Assistant Secretary of Treasury for Tax Policy, stated:

> The *Gregory* Court rested its decision on a determination that Mrs. Gregory's reorganization was outside the intent of Congress in enacting the reorganization provision. This test ought to be the first inquiry in any tax-shelter case, for if a court concludes that Congress intends the result sought by a taxpayer, that ends the matter, without regard to whether a judicial test has been offended. . . . It is worth restating . . . that the test is in two parts: only if a court concludes that the result was unintended by Congress need it inquire whether there was a purpose other than tax avoidance.

Gideon at 827-28 (footnote refs. omitted).

In most cases, it may be safely assumed that Congress does not intend to confer tax benefits upon transactions devoid of economic substance. Where, as in *Gregory*, there exists no specific guidance on the issue from Congress, the existence of such a non-tax purpose or effect might be viewed as an implicit condition precedent to the application of the income tax statute. Yet *Gregory* recognized the obvious truism that Congress is free to prescribe that transactions motivated solely by tax avoidance be given effect for tax purposes. "[T]he question for determination is whether what was done, *apart from the tax motive*, was the thing which *the statute intended.*" 293 U.S. at 469 (emphasis supplied). Thus, after *Gregory* was decided, Congress could have enacted a rule prescribing that the mere form of a transaction determined the application of the reorganization provisions. However much a court might disagree with such a rule, the court would not thereafter be free to ignore the Congressional mandate and disregard the very transaction involved in *Gregory*.

Instances in which Congress has chosen to waive the generally implicit and pervasive requirement of economic substance include the "safe-harbor" leasing rules enacted in section 201 of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981), which overruled the economic substance test articulated in *Frank Lyon Co. v. United States*, 435 U.S. 561(1978), and other authorities for characterizing a purported leasing transaction for tax purposes (*see* S. Rep. No. 144, 97th Cong., 1st Sess. 61-63 (1981) [1981-2 C.B. 432-33]; Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess.,

General Explanation of the Economic Recovery Tax Act of 1981, at 102-105 (Comm. Print 1981)); the special intercompany pricing rules applicable to Domestic International Sales Corporations in Code section 994, which allowed departure from the general rule of arm's length pricing (S. Rep. No. 437, 92d Cong., 1st Sess. 107-09 (1971)); and the special treatment accorded Alaska Native Corporations in section 1804(e)(4) of TRA-86. [*See* H.R. Rep. No. 841, 99th Cong., 2d Sess. Vol. II-843 (1986)]. *See also* Rev. Rul. 79-300, 1979-2 C.B. 112 (holding that Congress did not intend to require a non-tax profit motive for entitlement to tax benefits with respect to investments in low-income housing).

Section 108 was intended by Congress to have similar consequences; namely, a departure from the *Gregory* test in favor of an absolute rule granting dealers preferential tax treatment even in the face of having structured their transactions solely for the purpose of seeking tax benefits. The distate of the Tax Court and the Ninth Circuit for this arrangement does not constitute grounds for ignoring Congressional intent.

## CONCLUSION

For the foregoing reasons, the Petition should be granted.

Respectfully submitted,

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# APPENDIX

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**NOT FOR PUBLICATION**

**United States Court of Appeals**
**For the Ninth Circuit**

No. 89-70136
T. C. No. 3122-82

**MEMORANDUM***

David Cook,

*Petitioner*

v.

Commissioner of Internal Revenue,

*Respondent.*

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Appeal from the United States Tax Court.
Argued and Submitted April 18, 1990
San Francisco, California

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**Before: BEEZER and KOZINSKI, Circuit Judges and KLEINFELD**** , District Judge**

This is an appeal from a Tax Court decision. The parties have stipulated that David Cook, the petitioner-appellant, was a commodities dealer at all relevant times. They have further stipulated that he entered into a number of straddles on the London metals exchange in 1976 and 1977, which were economic shams, but not factual shams. The Commissioner disallowed approximately $1.5 million in capital loss deductions for the first leg of these straddles. The question on appeal is whether the Commissioner was bound, by certain 1986

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. R. 21.

** The Honorable Andrew J. Kleinfeld, United States District Judge, District of Alaska, sitting by designation.

modifications to section 108 of the Deficit Reduction of 1984, to allow the deductions. We decide that the Commissioner was correct.

The mechanics of these straddles are explained with precision in *Dewees v. Commissioner*, 870 F.2d 21, 23-24 (1st Cir. 1989), and *Glass v. Commissioner*, 87 T.C. 1087, 1107-1117 (1986). In over-simplified form, a straddle is a bet that the price of a commodity will rise, hedged with another bet made at the same time that the price will fall. The investor buys at one time, options both to buy and sell the same commodity in different future months. As the price of the commodity changes, one of these options will become more valuable, and the other less valuable. The two options are called the legs of the straddle. One leg will always show a loss, and the other a gain, if the price of the commodity changes by more than the commissions. A leg is usually closed out by purchasing an offsetting position. Profit can be made as the spread between the legs changes.

Mr. Cook's options, though, were not designed to generate a trading profit. Instead, they were designed to generate short-term loss in the first calendar year, and long-term capital gain in the second year of approximately equal magnitude. Competex, the broker Cook used, gave an example in its promotional literature of trades designed to generate a $100,000 first year tax deduction for a $12,000 investment, followed by an $88,000 long term capital gain in the second year. This would produce a tax saving of $28,000 for the 50% bracket taxpayer. The investor's entire $12,000 would be absorbed for premiums and commissions, so he would get no money back, only paper, but his economic advantage from tax savings would still be a net of $16,000. *Glass v. Commissioner*, 87 T.C. 1087, 1110 (1986).

To say that these options were not factual shams, as the parties stipulate, means that the paperwork for the purchases and sales of the options actually took place. To say, as the stipulation does, that the arrangement was an economic sham, means that it was designed never to make a trading profit. The Tax Court found that the straddles were designed to delay income tax obligations by one year, and to convert ordinary income into capital gains.

This description on its face suggests that no taxable event occurred during the first year, that is, no loss which can be recognized for tax purposes occurred. *See Gregory v. Helvering*, 293 U.S. 465,

469 (1935). Since the straddle had no business purpose, and was purely an artifice to generate a tax benefit without any change in the taxpayer's economic position, *Gregory* prohibits any recognition of loss. Analysis of the complexities of the 1984 and 1986 statutory changes results in no different conclusion.

The Deficit Reduction Act of 1984 has a section written just for pre-1982 straddles, section 108. The section breaks the straddle down into its separate legs, called positions. Before the 1986 retroactive change, which is the basis for Cook's petition, subsection (a) said that "in the case of any disposition" of a pre-1982 position, "any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit." Deficit Reduction Act of 1984, Pub.L. 98-369, §108(a) 98 Stat. 494, 630. This provision allowed the loss to be taken when the first leg was sold, even though the first leg was part of a straddle transaction which would not be fully closed out until the other leg was sold. The critical qualification in this provision was the phrase, "if such position is part of a transaction entered into for profit." This language plainly excluded transactions lacking economic substance from the benefit of subsection (a). Subsection (b) of the 1984 Act said that "for purposes of subsection (a), any position held by a commodities dealer ... shall be rebuttably presumed to be part of a transaction entered into for profit." This provision shifted the burden of proof regarding economic substance from the taxpayer to the Commissioner, if the taxpayer was a commodities dealer, but still plainly kept the "for profit" qualification in the statute as a condition of taking the tax benefit of the loss in year one.

Cook obviously had no claim to a deduction for the loss leg under the 1984 statute, and made none. His theory arises out of a change in the language, in the Tax Reform Act of 1986, Pub.L. 99-514, §1808(d) 100 Stat. 2085, 2817, §1808(d). The 1986 Act struck out the language in subsection (a), "if such position is part of a transaction entered into for profit." It substituted "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." *Id.*, §1808(d)(1). Subsection (a) provided, after the change, that with respect to any disposition of a position entered into before 1982 and forming part of a straddle, "any loss from such disposition" must be allowed for the tax year of the

disposition, if the loss was incurred in a transaction entered into for prof it, or in the alternative, if the loss was incurred in a trade or business. Subsection (b) was also amended. The new provision eliminated the "rebuttably presumed" language for commodities dealers, and provided instead that "[f]or purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business." The relevant portion of section 108 of the 1984 Act, as amended by section 1808 of the 1986 Act, now reads:

> (a) GENERAL RULE. – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions –
>
> > (1) which were entered into before 1982 and form part of a straddle, and (2) to which the amendments made by title V of such Act do not apply,
>
> any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) LOSS INCURRED IN A TRADE OR BUSINESS. – For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

Plugging the equation of subsection (b) into the conditions of subsection (a), we wind up with a 1986 law that says that in the case of a disposition of a position entered into before 1982 and forming part of a straddle, any loss from the disposition must be allowed for the taxable year of the disposition, if the loss was incurred by a commodities dealer in the trading of commodities. With the statute in this form, Cook has a position with some appeal. He is stipulated to be a commodities dealer, and the London trades were of commodities futures, so the statute seems to say that losses from the dispositions of the loss legs are allowable for the year of the loss. The "for profit" clause does not apply to commodities dealers, so he argues with some force that his paper losses in the first year are entitled to recognition.

The customers who were not commodities dealers lost their case in the Tax Court in *Glass v. Commissioner*, 87 T.C. 1087 (1986), because the transactions lacked economic substance. The Tax Court held that "the relevant transaction was petitioner's entire commodity tax straddle scheme." *Id.* at 1163. The Tax Court looked to the regulation at Regs. §1.165-1(b) allowing only a "bona fide" loss, with determination of loss to be governed by "[s]ubstance and not mere form." This analysis precluded focusing solely upon the losses in year one to the exclusion of the equivalent gain locked in for year two. *Glass* at 1163. The Tax Court noted the parallel between the revised language on straddles and the general provision on deductibility of losses:

> The amended section 108(a) expressly distinguishes between a loss incurred by a commodities dealer in the trade or business of trading commodities and a loss incurred in a commodities transaction entered into for profit though not connected with a trade or business. Thus, the language of section 108(a) is now completely harmonized with that of section 165(c)(1), which allows losses incurred in a trade or business, and section 165(c)(2), which allows losses incurred in any transaction entered into for profit, though not connected with a trade or business.

*Glass* at 1166. We determined that "it is the overall scheme which taints the deductibility of the year one losses." *Id.* at 1174. It concluded that the "multiple and complex tax straddle scheme encompassing prearranged results – lacked economic substance and was a sham," so the petitioners could not deduct the losses in year one. *Id.* at 1177.

This court affirmed *Glass* in *Keane v. Commissioner*, 865 F.2d 1088 (9th Cir. 1989). *Glass* involved some fourteen hundred taxpayers' claims, and has been affirmed in numerous other circuits and reversed in none. *See Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989), *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989), *Killingsworth v. Commissioner*. 864 F.2d 1214 (5th Cir. 1989), *Ratliff v. Commissioner*, 865 F.2d 97 (6th Cir. 1989), *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988), *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

Since *Glass* involved customers who were not commodities dealers, they were plainly bound by the "for profit" language in section 108(a). For commodities dealers, a distinction can be drawn, because the statute makes loss incurred by a commodities dealer equivalent to loss incurred in a trade or business, and commands the Commissioner to allow loss in the case of any disposition of a position of a pre-1982 straddle by a commodities dealer, regardless of whether the transaction was entered into for profit.

The Tax Court decided against Cook, in *Cook v. Commissioner*, 90 T.C. 975 (1988). The Court explained that in *Glass* "the putatively incurred losses were central to transactions lacking economic substance and were therefore shams. In effect, then, no losses were incurred." *Cook* at 985. Even though a commodities dealer did not need to satisfy the "for profit" requirement under the 1986 Act, he still needed a "loss," and there was none. A concurring opinion took the position that losses had to be recognized for year one, where the transaction was an economic but not a factual sham, for section 108 to mean anything for commodities dealers, but that the provision applied only to trades on the domestic exchange, not on an unregulated foreign exchange. *Id.* at 989-993. An additional concurrence suggested that both the implied domestic exchange requirement, and also the lack of economic substance, precluded deductibility of the first year putative losses.

We agree with the Tax Court majority that where the transaction was an economic sham, there was no "loss," even in year one. We think that this result is compelled by our previous decision in *Keane v. Commissioner*. 865 F.2d 1088 (9th Cir. 1989). Although *Keane* is factually distinguishable, because it involved investors who were not commodities dealers, nevertheless the *ratio decidendi* prevents the loss which is part of an economic sham transaction from being recognized at all. We do not reach the issue of trades on foreign commodities exchanges, discussed by the concurring Tax Court opinions.

This Circuit has already committed itself to several principles governing commodities straddles. *Sochin v. Commissioner*. 843 F.2d 351 (9th Cir. 1988), a case arising out of straddles not on the London metals exchange, determined that "the 'reasonable expectation of

profit' standard is not applied until the court determines that the transaction is itself bona fide, i.e. that it is not a sham.... Thus, the Tax Court in the present case never reached section 108." *Sochin* at 354, n.6. Though there was disagreement on some other points, all the judges in *Sochin* agreed that section 108 of the 1984 act did not apply to transactions which were not bona fide.

In *Keane v. Commissioner of Internal Revenue*, 865 F.2d 1088 (9th Cir. 1989), we affirmed the Tax Court's decision in *Glass*. There, the Tax Court held that individuals who were not commodities dealers could not deduct losses caused by their straddles as the transactions lacked economic substance. *See* pp. 4-5, *supra*. We found that the Tax Court "correctly considered the entire two-year sequence of transactions when it determined that the London option transactions lacked economic substance and were designed merely to create deductible losses." *Id.* at 1091. In *Keane*, our *ratio decidendi* was the principle stated in *Sochin*, that "the 'reasonable expectation of profit' standard is not applied until the court determines that the transaction is itself bona fide, i.e., that it is not a sham." *Keane v. Commissioner*. 865 F.2d 1088, 1092 (9th Cir. 1989); *Sochin v. Commissioner*, 843 F.2d 351, 354, n.6 (9th Cir. 1988).

This analysis compels the result in the case at bar. The logic of our analysis in the *Sochin* footnote and in *Keane* is that one must ask, first, was there a bona fide loss, and then, only if the answer is yes, does one ask whether the loss was incurred in a trade or business or alternatively, incurred in a transaction entered into for profit. When we apply this logic to Mr. Cook's transactions, we get the same result as the Tax Court, because he had no bona fide loss. Without a bona fide loss from the disposition, there is nothing to allow.

Cook argues that this reading makes a nullity of the commodities dealer provision in section 108. He argues that so long as the transaction is not a factual sham, the commodities dealer provision in §108 must be designed to allow deductibility of losses in economic sham transactions, because otherwise the provision would be a nullity. This argument challenges us to imagine a transaction by a commodities dealer which generates a recognizable loss, yet the loss is not incurred in a transaction entered into for profit.

We do not need to go this far to give meaning to the statute. The words of the statute now precisely track the hoary formula of §165(c)(1) and §165(c)(2) of the Code:

> (c) LIMITATION OF LOSSES OF INDIVIDUALS. – In the case of an individual, the deduction under subsection (a) shall be limited to –
>
> (1) losses incurred in a trade or business;
> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business
> ....

Internal Revenue Code, 26 U.S.C. §165 (1986). It is unlikely that Congress meant anything different by its use of these terms of art in §108 of the 1984 Act as amended by the 1986 Act, from what it has meant for many years in §165 of the Code. *Cf. Landreth v. Commissioner*, 859 F.2d 643, 648 (9th Cir. 1988) (after the 1986 amendments, "the 'entered into for profit' language in section 108 should be interpreted in the same way as the identical language in section 165(c)(2)."); *Miller v. Commissioner*, 836 F.2d 1274 (10th Cir. 1988); *accord Glass*, 87 T.C. at 1166. Tax recognition is generally denied to paper losses in transactions having no economic effect, whether they take place in a trade or business or not, without ever reaching the issue of subjective motive. *See Gregory v. Helvering*, 293 U.S. 465 (1935). Once Congress amended §108 in 1986 to make the language track the traditional §165 language, it eliminated the need to construe §108 in a fashion distinct from §165. The structural parallelism of the sections gives us the meaning.

A reading such as the one suggested by Mr. Cook would mean that a person who owned a seat on a commodities exchange during the relevant years would, by an economically meaningless shuffling of paper, have been relieved of any obligation to pay taxes at ordinary income rates. That would be an anomalous provision. It may be that commodities dealers occasionally have to engage in trades in which the transactions themselves are not intended to generate a trading profit, but are necessary to the business of being a commodities dealer. For example, *Dewees* describes a London Metal Exchange brokers' "practice of 'laying off' their trades with each client, each day, by entering into offsetting transactions with other buyers or sellers. This

way the brokers are exposed to no net market risk, and do not hold interests adverse to their clients'." *Dewees v. Commissioner*, 870 F.2d 21, 23-24 (1st Cir. 1989) The Exchange does not require this practice. *Glass v. Commissioner*, 87 T.C. 1087, 1097, and 1159 n. 123 (1986). Lay-off trades of this kind might be within the traditional meaning of the trade or business branch of §165, even though they would not generate deductible losses for persons not in the commodities dealer business. This would be the kind of transaction which Mr. Cook challenges us to imagine. But regardless of whether Congress went through a similar intellectual process, we think its use of the §165 language imports the traditional *Gregory* analysis.

The Second Circuit has reached the same conclusion in *DeMartino v. Commissioner*. 862 F.2d 400 (2d Cir. 1988). That case also involved a commodities dealer, and the 1986 changes to section 108 of the 1984 Act, and held that "section 108(a) does not apply to straddle transactions that are shams." *Id.* at 407. The decision involved transactions which were economic but not factual shams. *DeMartino* applies "the basic rule of law ... that taxation is based upon substance, not form," *Id.* at 406, citing *inter alia Gregory v. Helvering*, 293 U.S. 465 (1935), and *Knetsch v. United States*, 364 U.S. 361 (1960).

Cook suggests that we accept his reading based upon a close analysis of a snippet of legislative history. The legislative history, though, is considerably more ambiguous that the statute. Remarks on the floor by Senators and Representatives cast additional doubts on which legislative history the different actors in the process wanted courts to use. *Landreth v. Commissioner*, 859 F.2d 643, 646 n.8 (9th Cir. 1988). We can more appropriately apply the words of the statute as voted upon by both Houses and signed into law by the President. *See Miller v. United States*, 836 F.2d 1274, 1281-1282 (10th Cir. 1988).

We interpret the word "losses" in section 108 in accord with the ordinary English meaning of the word, the structural parallel with §165 of the Code, and the 55 year old *Gregory* tradition, to avoid recognizing paper transactions which have no purpose or economic consequence other than tax avoidance. This results in a statutory construction which is consistent with ordinary English usage and other

areas of tax law, and is economically practical as applied to the commodities industry.

Affirmed.

**DAVID COOK. PETITIONER**
**v.**
**COMMISSIONER OF INTERNAL REVENUE,**
*RESPONDENT*

Docket No. 3122-82.

Filed May 12, 1988.

Held, availability to petitioner of per se dealer rule determined under sec. 108(b) of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by sec. 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

*Eric R. Fox,* for the petitioner.
*Carolyn A. Boyer,* for the respondent.

## OPINION

NIMS, *Judge:* This matter is before the Court on petitioner's motion for reconsideration of findings and opinion. Petitioner was one of the petitioners in the London options consolidated group as to which the Court published an opinion denominated *Glass v. Commissioner,* 87 T.C. 1087 (1986) (Court-reviewed).

On November 23, 1987, the Court promulgated the following:

## ORDER

On June 17, 1987, petitioner in the case at docket No. 3122-82 filed a Motion for Reconsideration of Findings and Opinion in *Glass v. Commissioner,* 87 T.C. 1087 (1986). Petitioner's Motion for Reconsideration of Findings and Opinion in the case at docket No. 3122-82 was calendared for hearing on July 22, 1987. The parties in the case at docket No. 3122-82 were present at the July 22, 1987 hearing, and the hearing was continued to September 30, 1987. Upon due consideration, it is

ORDERED that petitioner's Motion for Reconsideration of Findings and Opinion in *Glass v. Commissioner*, 87 T.C. 1087 (1986), is hereby granted in that the issues to be resolved in the case at docket No. 3122-82 are the following:

Whether the per se presumption applicable to the losses of a dealer under section 108 of the Deficit Reduction Act of 1984, as amended by section 1808(d) of the Tax Reform Act of 1986, is applicable to losses claimed with respect to straddle transactions undertaken on a foreign exchange not regulated by a United States entity or to straddle transactions which the Court has previously determined "lacked economic substance and w[ere] a sham."

The parties in the case at docket No. 3122-82 submitted to the Court a statement of the above issues to be resolved. It is further

ORDERED that the case at docket No. 3122-82 is severed from the group previously consolidated on the London Option issue in *Glass v. Commissioner*, 87 T.C. 1087 (1986).

For convenience, section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, and the later amendment to section 108 made by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817, are reproduced in Appendix A.

In our *Glass* opinion, we stated our understanding from the record that "The case before us does not involve commodities dealers." (87 T.C. at 1167.) By amendment to petition filed with leave of Court on July 22, 1987, petitioner amended paragraph 5(c) of his petition to allege the following:

During all of 1976 and 1977, Petitioner was a commodities dealer within the meaning of section 1402(i)(2)(B) of the Internal Revenue Code of 1954.

In his responsive pleading, respondent admits that during 1976 and 1977, "petitioner was a commodities dealer within the meaning of section 108(f) of the Tax Reform Act of 1984, as amended by the Tax Reform Act of 1986." Section 108(f) adopts the definition of "dealer" contained in section 1402(i)(2)(B).[1] Consequently, at least

[1] Except where reference is made to sec. 108, all section references are to sections of the Internal Revenue Code in effect for the years in issue.

insofar as petitioner is concerned, our statement in *Glass* that the case did not involve commodities dealers was inaccurate.

It having now been agreed that petitioner was a dealer during 1976 and 1977, the parties on brief focus their attention on the following questions:

(1) Whether the per se rule under section 108(b) is available for losses claimed from a "London options transaction" (defined in *Glass*, 87 T.C. at 1155) which the Tax Court has determined lacks economic substance and was a sham; and

(2) Whether the per se rule under section 108(b) is applicable to losses claimed from transactions undertaken on a foreign exchange that is not regulated by a U.S. entity.

At the time he filed his petition in this case, petitioner resided in Los Altos, California.

Respondent's statutory notice determined deficiencies in petitioner's income tax for the calendar years 1976 and 1977 in the amounts of $862,188 and $136,108, respectively. Although the statutory notice listed five different types of adjustments to petitioner's taxable income, substantially all of the deficiency is attributable to the disallowance of capital losses in the amounts of $1,250,022.80 and $217,782.00 derived from his commodity straddle trading activities during 1976 and 1977, respectively. The only issue still contested by petitioner is whether any capital losses incurred by petitioner from his straddle trading activities during the years in issue were properly deducted.

Petitioner's commodity straddle trading activities were based upon trading conducted on the London Metal Exchange (LME), and were executed by or through Competex, S.A., as broker/dealer. The trading strategy of Competex, S.A., vis-!-vis the so-called London options transaction, is described in detail in *Glass* and need not be repeated here. See 87 T.C. at 1107-1117.

During the course of the trial in *Glass*, the Deficit Reduction Act of 1984 (DEFRA) was enacted. Section 108(a) of DEFRA provided in general that certain losses from the disposition of one leg of a straddle entered into prior to 1982 were deductible if the straddle was entered into for profit. Section 108(b) of DEFRA also provided in

general that straddle transactions of commodities dealers were rebuttably presumed to be entered into for profit.

Subsequently, section 108 of DEFRA was amended by section 1808(d) of the Tax Reform Act of 1986 (TRA-86). Amended section 108 of DEFRA (unless otherwise stated, all references hereinafter to "section 108" shall mean section 108 of DEFRA, as amended by section 1808(d) of TRA-86) provided that losses attributable to the disposition of a leg of a commodity straddle which were incurred in a trade or business before 1982 were deductible and that losses arising from the disposition of a straddle leg which were incurred by commodities dealers, as defined in section 1402(i)(2)(B), were deemed per se to be incurred in a trade or business.

In *Glass,* we held that no petitioner was entitled to deduct the commodity trading losses in issue because the transactions in which they were incurred lacked economic substance. We discussed section 108, but although we noted that "amended section 108 * * * makes it clear that losses incurred by commodities dealers trading in commodities are deductible under section 108 since they are losses incurred in a trade or business" (87 T.C. at 1167), we did not pursue this avenue because, as stated, we understood that "The case before us does not involve commodities dealers." (87 T.C. at 1167.)

In *King v. Commissioner,* 87 T.C. 1213 (1986) (Court-reviewed), decided after *Glass,* we held that an individual commodities dealer who entered into straddle transactions prior to 1982 was entitled to deduct his losses under section 108 without regard to the existence of a profit motive. We held that this is a per se rule and no longer a rebuttable presumption. 87 T.C. at 1218-1219. After the decision in the *King* case was published, petitioner filed the motion under present consideration.

The parties were directed by the Court to make the same assumption for purposes of argument as the Court made in *Glass;* namely, "that the commodity options and futures contracts which [petitioner] entered into were actual contracts."[2] See *Glass,* 87 T.C. at 1172. Thus, just as in *Glass,* we focus our attention not on whether petitioner has sufficiently authenticated his transactions (i.e., proved that there were actual transactions), but rather whether such transactions, assuming

[2] Respondent has never conceded that the contracts were actual contracts.

they are proven to have occurred, fall within the ambit of the per se rule of section 108.

**Petitioner's Position**

Petitioner asks the Court to conclude that, as a matter of law, losses incurred by petitioner in 1976 and 1977 from the disposition of certain commodity straddle positions were incurred in a trade or business and were therefore deductible. Petitioner's contention "rests exclusively" (petitioner's opening brief, p.6) on section 108 (and very specifically section 108(b)) which, in relevant part, now provides as follows:

**Sec. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.**

(a) GENERAL RULE. – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions –

(1) which were entered into before 1982 and form part of a straddle * * *

any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, * * *

(b) Loss INCURRED IN A TRADE OR BUSINESS. – For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

* * * * *

(f) COMMODITIES DEALER. – For purposes of this section, the term "commodities dealer" means any taxpayer who –

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), * * *

Petitioner argues that during 1976 and 1977, the years in issue, he was a commodities dealer within the meaning of section 108(f), a

fact not in dispute. During 1976 and 1977, he incurred losses from the disposition of commodity straddle positions. From this petitioner argues that under section 108 these two facts, taken together, inescapably lead to the conclusion that he must be irrebuttably presumed to have incurred losses in a trade or business and that such losses must be allowed.

For purposes of this proceeding, petitioner concedes that his commodity straddle transactions lacked economic substance and were a sham in the economic sense. (Petitioner's opening brief, p.6.)[3] This is consistent with our holding in *Glass*. 87 T.C. at 1177.

**Respondent's Position**

Respondent argues that the per se rule of section 108(b) is not available for losses claimed from the London options transaction because the transaction was not bona fide. The Court found the transaction to be a sham in substance, prearranged solely to achieve a tax-avoidance objective. As such, section 108(a) did not apply in determining whether the losses were allowable. Because section 108(a) was not at issue, the per se rule of section 108(b) does not come into play. Furthermore, Congress did not intend for the per se rule to apply to transactions that were fictitious or prearranged. The London options transaction was prearranged.

Respondent also argues that the per se rule does not apply to transactions on foreign exchanges like the London Metal Exchange since an assumption that the transactions were bona fide cannot be made.

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Petitioner maintains that the word "sham" can have more than one meaning, and that respondent can prevail on his sham argument only if petitioner's transactions were a sham in the sense of being fake or fictitious, and cannot prevail if the transactions were a sham in the sense that they lacked profit motivation. He further maintains that there is no suggestion that economic substance is in any way a

[3] Petitioner reserves the right to argue the economic substance issue, if appropriate, in any other proceeding.

prerequisite to application of the per se rule of section 108. Petitioner thus implicitly concedes that the benefit of the dealer per se rule in section 108(b) is unavailable in commodity straddle cases involving fictitious transactions, despite the section's flatly stated fiat.

Not surprisingly, petitioner places heavy emphasis upon our holding in *King v. Commissioner, supra* Marlowe King was a registered member of the Chicago Mercantile Exchange (CME), a domestic board of trade subject to regulation by the Commodities Futures Trading Corporation (CFTC). King was a commodities dealer within the meaning of section 1402(i)(2)(B). During 1980 and 1981, King entered into certain gold straddles. Liquidation of certain of the legs of his straddle positions generated a short-term capital loss of $1,452,900 in 1980 which King deducted on his 1980 return and which the Commissioner disallowed.

King filed a motion for summary judgment asking for a ruling that, as a matter of law, the 1980 losses referred to in the preceding paragraph were deductible under section 108. The Commissioner sought to have King's motion denied on three separate grounds:

(1) Taxpayer failed to address the threshold issue of whether the transactions at issue were shams;

(2) Taxpayer failed to show that he is entitled to the presumption under section 108(b) of the Tax Reform Act of 1984 and Temporary Treasury Regulations Section 1.16513T; and

(3) Even if taxpayer were entitled to the presumption, a trial would nevertheless be required to resolve the "for profit" issue which is inherently factual. (87 T.C. at 1216.)

In *King* the deficiency notice asserted that "The transactions at issue were either shams or devoid of the substance necessary for recognition for federal income tax purposes." (87 T.C. at 1216.) However, in his defense against King's motion for summary judgment, the Commissioner failed to allege or support any facts tending to demonstrate that the transactions in question were shams in any sense. The taxpayer, on the other hand, included in his affidavit detailed facts supporting the bona fide nature of his trading in gold contracts. We held that "Under these circumstances, respondent has

not shown that there is a genuine issue of sham for trial." 87 T.C. at 1217.

In *King* we granted summary judgment for the taxpayer on the ground that the gold straddles were not fictitious, i.e., they were actual contracts, and, as previously stated, that the taxpayer was not required to show a profit motive. The Commissioner did not argue nor did we consider whether the straddles were prearranged and lacked economic substance. Cf. *DeMartino v. Commissioner,* T.C. Memo. 1986-263 (straddles which were prearranged, were not executed at free market prices, reflected virtually no changes in the spreads, and were executed in an abnormally thin market held to be shams).

While reaching the foregoing result in *King,* we nevertheless expressly refrained from drawing any conclusions as to what the result might be under other circumstances. In footnote 8, page 1219, of *King,* we said:

The per se rule of sec. 108(b) would not preclude us from finding for respondent in another case. The legislative history of the provision makes clear that it was not intended to apply "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H. Rept. 99-426, at 911 (1985). [1986 3 C.B. (Vol. 2), at 911.] See also *DeMartino v. Commissioner,* T.C. Memo. 1986-263.

Respondent relies primarily upon our holding in *Glass v. Commissioner, supra,* that the London options transaction lacked economic substance and was therefore a sham. This conclusion was based not upon a finding that the commodity contracts were fake or fictitious, but rather on a finding that even if the straddles consisted of actual contracts (a fact which was left undetermined), the transactions, nevertheless, lacked economic substance and were a sham because the realization of tax losses in year one of the London options transaction was preordained. We further held that section 108 is not available to permit loss deductions where the sham involves a series of transactions having no business or profit-making function apart from obtaining tax deductions.[4]

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[4] As petitioner has pointed out, see *supra,* we drew no distinction between straddle transactions of dealers and investors.

Petitioner somewhat tangentially acknowledges that the legislative history of amended section 108 suggests an exception to the dealer per se rule by referring to the language quoted from the House report in footnote 8 of *King*. For completeness and in fairness to petitioner, we should also note that the Conference Committee statement of managers states that "If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person." H. Rept. 99-841 (Conf.), at II-845, 1986-3 C.B. (Vol. 4) 845.

This leads us to a consideration of two recent Circuit Court cases which, in analyzing the profit motive standard of the 1984 version of section 108, juxtapose diametrically opposing views as to the appropriateness of using the legislative history as an aid in construing the section 108 statutory language.

The first of these cases is *Miller v. Commissioner*, 836 F.2d 1274 (10th Cir. 1988), revg. 84 T.C. 827 (1985). The Circuit Court held that the phrase "transaction entered into for profit" found in section 108(a) is to be construed consistently with prior case law under section 165(c)(2), commencing with *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938), and followed for almost 50 years. 836 F.2d at 1278. In a footnote in *National Grocery*, the Supreme Court said that "the deductibility of losses under [the predecessor of section 165(c)(2)] may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit." 304 U.S. at 289 n. 5. In *King v. United States*, 545 F.2d 700, 708 (10th Cir. 1976), the 10th Circuit had held that "in order to deduct a loss under sec. 165(c)(2) the taxpayer must show that profit was the primary motivation." In *Miller* the 10th Circuit held that since section 108(a) is clear on its face in light of this past history, resort to the legislative history would be inappropriate. In so concluding, the court acknowledged that its decision was in conflict with that of the Ninth Circuit in *Wehrly v. United States*, 808 F.2d 1311 (9th Cir. 1986), discussed *infra*

Following the 10th Circuit's line of thought, it could be argued that a reading of the statutory language in the case now before us, without resort to the Committee reports, would go a long way in carrying the day for petitioner.

The second significant Circuit Court case is *Wehrly v. United States, supra* In this case, the Ninth Circuit (the court to which this case would be appealed), construing the identical language of section 108 later construed by the *Miller* Circuit Court, held that the term "transaction entered into for profit" as used in section 108 allows a deduction for loss when the taxpayer had a reasonable expectation of profit, and does not require profit to have been the dominant motive of the transaction.[5] In reaching this result, the Ninth Circuit found that the subject phrase was sufficiently ambiguous in the section 108 context to warrant a study of the legislative history for interpretative assistance. 808 F.2d at 1314. The court then went on to quote language in the Conference Committee report pointing toward the appropriate profit motive standard to be applied. 808 F.2d at 1314.

Section 108(b) in its present form is straightforward enough: "For purposes of subsection (a), any *loss incurred* by a commodities dealer in the trading of commodities shall be treated as a *loss incurred* in a trade or business." (Emphasis added.) Nevertheless, as we have emphasized earlier, the House report flatly states that "the presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H. Rept. 99-426, at 911, 1986-3 C.B. (Vol. 2) 911.

The straddles in question were unquestionably prearranged, and petitioner does not dispute this. The next question is whether we may appropriately consider the legislative history in construing section 108(b), because the legislative history expressly provides a caveat to the per se rule. We believe that it is appropriate for us to do so.

In *Perlin v. Commissioner,* 86 T.C. 388, 419 (1986), we stated that "When interpreting a statute, and especially a new statute, a court may look to legislative history for interpretative assistance." (Citations omitted.) See also *King v. Commissioner,* 87 T.C. at 1219 n. 7. The Supreme Court itself has said that "When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no 'rule of law' which forbids its use [footnote ref. omitted],

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[5] In *Glass v. Commissioner,* 87 T.C. 1087, 1177 (1986), we distinguished *Wehrly* on the ground that the lack of economic substance in the London Option Transaction negates the existence of *any* profit motive.

however clear the words may appear on 'superficial examination.'" *United States v. American Trucking Associations.*, 310 U.S. 534, 543-544 (1940); quoted with approval in *Train v. Colorado Public Interest Research Group,* 426 U.S. 1, 10 (1976). We perhaps adumbrate the obvious by emphasizing this point, but we believe it is necessary to explain why we must go beyond a "superficial examination" of the straightforward language of section 108(b).

The "prearranged" language of the Committee report casts a shadow on the otherwise bright-line parameters of the per se rule. Therefore, where the transactions were prearranged, as here, we must examine them to ascertain whether the taxpayer actually incurred losses, a necessary precondition to the application of the per se rule.

In *Glass,* we stated that "the critical inquiry in this case must be whether the losses *putatively incurred* under petitioners' tax straddle scheme * * * are deductible as claimed, or whether the London options transaction lacked economic substance and was therefore a sham." (Emphasis added.) 87 T.C. at 1172. In *Glass,* the putatively incurred losses were central to transactions lacking economic substance and were therefore shams. In effect, then, no losses were incurred. It follows that the per se dealer rule is not available to petitioner since section 108(b) applies only to "any loss" incurred by a commodities dealer. Furthermore, we think it would be highly anomalous to disallow loss deductions to over 1,000 petitioners claiming them under the London options transaction, as we have done in *Glass,* while allowing them to petitioner, even though a dealer, on the self-same transaction.

On brief, petitioner argues that "Any argument that the transactions were prearranged within the meaning of footnote 8 in the *King* case [87 T.C. 1213 (1986)] because they were structured to produce no economic profit or loss cannot withstand scrutiny because it proves too much. Any taxpayer who entered into straddle transactions with a motive to make a profit apart from tax savings has no need to rely on section 108."

The weakness in petitioner's argument is amply illustrated by the *Miller* and *Wehrly* cases on appeal, *supra,* each of which applied a standard of proof to the "transaction entered into for profit" issue which differed from the other: "reasonable expectation of profit" in *Wehrly* versus profit as "primary motivation" in *Miller.* Section

108(b), however, absolves dealers of the need to meet *any* specific profit-motive standard so long as the dealer's transactions are not fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member. Compare *Perlin v. Commissioner,* 86 T.C. 388, 415-416 (1986), with *DeMartino v. Commissioner,* T.C. Memo. 1986-263. Thus, our holding does not, as petitioner argues, drain the per se rule of its vitality.

It bears repeating that in *King v. Commissioner,* 87 T.C. 1213 (1986), the Commissioner did not argue that the straddle transactions were prearranged, but merely asserted without further facts to support the assertion that the transactions were shams in the sense of being fake or fictitious. Consequently, this Court had no occasion to consider whether the transactions were shams because of a lack of economic substance. We again note, moreover, the regulated nature of the exchange upon which the trades in *King* were made. 87 T.C. at 1217. By contrast, the contracts in *Glass* were tailor-made between broker/dealer and taxpayer, not transacted through "open outcry" on the LME ring, and as the facts in *Glass* amply bear out, were deliberately prearranged.

We accordingly hold that it is appropriate before applying the per se rule of section 108(b) to enquire whether straddle transactions were fictitious, prearranged, or otherwise in violation of the rules of the exchange, and if so, whether there were losses actually incurred.[6] Since the straddle transactions in *Glass* were prearranged, causing the transactions to lack economic substance, petitioner incurred no losses to which the per se rule can be applied. We therefore hold for respondent.

Because we hold for respondent on the above grounds, we need not address his other arguments.

*An approriate order will be issue.*

Reviewed by the Court.

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[6] Cf. *Sochin v. Commissioner,* 843 F.2d 351, 353 n. 6 (9th Cir. 1988), affg. *Brown v. Commissioner,* 85 T.C. 968 (1985) (the "reasonable expectation of profit" standard of sec. 108(a) is not applied until the Court determines that the transaction is itself bona fide, i.e., that it is not a sham).

STERRETT, CHABOT, PARKER, KORNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, PARR, WELLS, and WHALEN, JJ., agree with the majority opinion.

GERBER and RUWE, JJ., did not participate in the consideration of this case.

## APPENDIX A

Division A of the Deficit Reduction Act of 1984,
Pub. L. 98-369, 98 Stat. 494, 630 (Section 108)

**Sec. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.**

(a) GENERAL RULE. — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT. — For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

(c) NET LOSS ALLOWED WHETHER OR NOT TRANSACTION ENTERED INTO FOR PROFIT. — If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to

accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALER. – For purposes of this section, the term "commodities dealer" has the meaning given to such term by section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle).

(g) REGULATED FUTURES CONTRACTS. – For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. – Subsection (b) shall not apply to any syndicate (as defined in section 1256(e)(3)(B) of the Internal Revenue Code of 1954).

Tax Reform Act of 1986, Pub. L. 99-514,
100 Stat. 2085,2817 (Section 1808(d))

(d) SECTION 108. – Section 108 of the Tax Reform Act of 1984 is amended –

(1) by striking out "if such position is part of a transaction entered into for profit" and inserting in lieu thereof "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business",

(2) by striking out subsection (b) and inserting in lieu thereof the following:

"(b) Loss INCURRED IN A TRADE OR BUSINESS. – For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.",

(3) by striking out the heading for subsection (c) and inserting in lieu thereof the following:

"(c) NET LOSS ALLOWED. –",

(4) by striking out subsection (f) and inserting in lieu thereof the following:

"(f) COMMODITIES DEALER. – For purposes of this section, the term 'commodities dealer' means any taxpayer who –

"(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

"(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of –

"(A) 1 or more individuals described in paragraph (1), and

"(B) 1 or more members of the families (as so defined) of such individuals.", and

(4) by striking out subsection (h) and inserting in lieu thereof the following:

"(h) SYNDICATES. – For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business."

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WHITAKER, *J.*, concurring: I find the majority s reasoning in this case to be faulty and the interpretation of section 108(b) of the Tax Reform Act of 1984, as amended by the Tax Reform Act of 1986,

to be erroneous.[1] However, respondent in this case makes the alternative argument that section 108(b) and (f) was not intended to apply to transactions executed on a foreign exchange. I find this argument to be dispositive of the case and conclude, therefore, that the majority has reached the right result but for the wrong reasons. Therefore, I concur in the result only.

Section 108(b) provides –

For purposes of subsection (a), any loss incurred by commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

However, this unambiguous language is qualified in the report of the House Ways and Means Committee[2] which states in part that:

Further, the presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer was a member. * * * [H. Rept. 99-426, at 911 (1985), 1986-3 C.B. (Vol. 2) 911.]

The hub of the majority opinion seems to be the conclusion that petitioner incurred no loss since the transactions lacked economic substance and that therefore we need never reach section 108.[3] With this reasoning I disagree. Losses actually incurred are disallowed for tax purposes where the transaction lacks economic substance. *Frank Lyon Co. v. United States,* 435 U.S. 561, 573 (1978); *Knetsch v. United States,* 364 U.S. 361, 366 (1960). Unless losses are incurred, the issue does not arise. We found in *Glass* that losses were incurred. See *Glass v. Commissioner,* 87 T.C. 1087, 1105-1106, 1114 (1986). The losses are described in the opinion as "putatively incurred" but, in context, that language must refer to the tax Consequences of the actual losses.

The majority also attempts to find support for the conclusion that section 108 does not apply in the legislative history by relying on the

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[1] All references to sec. 108 are intended to refer to that provision as amended by the Tax Reform Act of 1986.

[2] The conference follows the House bill in this respect. H. Rept. 99-841 (Conf.), at II-845 (1986), 1986 C.B. (Vol. 4) 845.

[3] See majority opinion at page 986 where the majority concludes that "Since the straddle transactions in *Glass* were prearranged, causing the transactions to lack economic substance, petitioner incurred no losses to which the per se rule can be applied."

word "prearranged." Again I disagree with the majority's analysis. I am constrained to conclude that the Ways and Means Committee used the word "prearranged" as equivalent to "fictitious" and as a way of describing that species of transactions which we treat as factual shams as in *Brown v. Commissioner, 85* T.C. 968 (1985), affd. sub nom. *Sochin v. Commissioner, 843* F.2d 351 (9th Cir. 1988), and *Julien v. Commissioner,* 82 T.C. 492 (1984). In my judgment, there is no basis for expanding the exclusion from the scope of section 108 beyond that specified in the House Ways and Means Committee report, which should constitute the maximum reach of our legislative interpretation.

This and the *Glass* opinion are the first occasions in which this Court has used "prearranged" to mean other than "false" or "fictitious."[4] In *Glass,* we seem to have used the word "prearranged" in a

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[4] So far as I have been able to determine this Court has consistently used "prearranged" to mean "rigged," "fixed," "artificial," i.e., a "factual sham." The "manipulation" that occurred in *DeMartino v. Commissioner,* T.C. Memo. 1986-263, was price manipulation in trades that violated the rules of the exchange. Unless this Court is prepared to disregard all transactions on the London Metal Exchange, the kind of factual findings made in *DeMartino* are required here. All the other cases cited by my colleagues likewise presented false or fictitious transactions — so-called factual shams — found by this Court to be shams only after the Court had found the necessary facts to support the conclusion that the transactions were not bona fide. *Forseth v. Commissioner,* 85 T.C. 127, 149 (1985), affd. 813 F.2d 293 19th Cir. 1987). We stated this principle in a recent Court-reviewed opinion, *Perlin v. Commissioner,* 86 T.C. 388, 415 (1986) as follows:

"Alleged transactions involving commodity futures contracts which are in fact prearranged or fictitious will not be recognized for Federal tax purposes. See *Brown v. Commissioner,* 85 T.C. 968 (1985); *Forseth v. Commissioner,* 85 T.C. 127 (1985); *Miller v. Commissioner,* 84 T.C. 827 (1985), on appeal (10th Cir., Nov. 20, 1985); *Julien v. Commissioner,* 82 T.C. 492 (1984). * * *"

In *Glass v. Commissioner,* 87 T.C. 1087, 1172 (1986), we made no finding that the transactions were factual shams. In contrast, we expressly hypothesized that the transactions were real:

"For purposes of the discussion which follows we assume, without deciding, that the commodity options and futures contracts which petitioners entered into were actual contracts. In thus postulating this assumption, we necessarily focus our attention not on whether petitioners have sufficiently authenticated their transactions (i.e., proved that there were actual transactions), but rather whether such transactions, even if actually proven, are nevertheless sufficient to accomplish the tax results which petitioners contemplated. * * *"

pejorative way to refer to transactions designed to achieve a desired result, i.e., losses. Although we described the transactions in *Glass* as prearranged, our actual holding was that the transactions lacked economic substance and were therefore shams. Here, the opinion refers to the transactions as prearranged apparently to enhance the opinion's effort to come within the exclusion from the benefit of section 108(b) set forth in the committee report. However, the majority makes no effort to determine what Congress intended by its use of the word "prearranged," and, furthermore, the majority's holding is not based on whether the transactions were prearranged, but is based on the conclusion that no losses were incurred.[5]

The 1986 committee report explains the necessity for the inclusion of section 108(b) in the 1984 Act by stating that a profit-motive presumption was provided for commodities dealers "because of the inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions when the taxpayer was in the trade or business of trading in commodities." H. Rept. 99-426, at 910-911 (1985), 1986-1 C.B. (Vol. 2) 910-911. Although transactions without economic substance but motivated by tax considerations are normally not recognized for tax purposes *(Frank Lyon Co. v. United States, supra),* Congress, by enacting section 108, intended to allow straddle trading losses of commodities dealers. Those transactions are not to be tested for economic substance, at least, as I conclude, where effected in the domestic market. Thus, petitioner would fit within section 108(b) unless Congress intended to protect dealers only when trading in U.S. markets. The majority opinion simply writes section 108 off the books, without recognizing that more than 80 years ago the Supreme Court held that there is a presumption against interpreting a statute in a way that renders it ineffective or futile. *Bird v. United States,* 187 U.S. 118, 124 (1902). This rule of statutory construction is particularly apt where, as here, Congress restated retroactively with some modification in the 1986 Act the provision first enacted in the 1984 Act. I believe the majority should instead focus on the scope of the section.

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[5] In my opinion, in order for the majority to rely on the word "prearranged" (assuming, as I conclude, that Congress used that word as synonymous with "fictitious") the majority could not rely on *Glass*, but would have to make express findings that the transactions were fictitious.

Section 108(f) of the act defines a commodities dealer as a taxpayer who is an individual described in section 1402(i)(2)(B). Section 1402(i)(2)(B) defines a commodities dealer as "a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract member by the commodities futures trading commission." The parties here agree that petitioner is such a commodities dealer. Majority opinion at pages 976-977. But that does not answer the inquiry. To determine the scope of section 108, I look again to the committee report. That report provides in part:

If a person qualifies as a commodity dealer. the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, *whether it was traded on an exchange on which the dealer was a member,* or whether an identical position was reestablished on the same trading day or subsequently.

In the cases of trade on a domestic exchange described in Code section 1402(i)(2)(B), the identification of positions disposed of shall be as provided in exchange procedures and records of the exchange or clearing house shall be controlling in the absence of proof that the rules were violated. * * * Further, the presumption would not be available in any cases where the trades were fictitious, prearranged or *otherwise in violation of the rules of the exchange in which the dealer is a member.*

[H. Rept. 99-426, at 911 (1985), 1986-3 C.B. (Vol. 2) 911; emphasis supplied.]

The committee obviously was concerned with the normal trading pattern of commodities dealers it was intending to benefit. It was only the losses incurred in that normal trading pattern which would present the problem of classification between business and tax motivation. Trading on the London metals exchange does not comport with the rules of trading in the United States on any of the several domestic commodities futures exchanges. The London options transactions would have been in violation of the rules of the commodities exchanges in this country. The presumption of section 108(b) would, therefore, not apply to trades by petitioner on the London Metal Exchange.

Moreover, the definition of the term "commodity dealers" as set forth in section 1402(i) refers to a person who is engaged in trading section 1256 contracts. Section 1256(b) defines a section 1256 contract to mean –

(1) any regulated futures contract,
(2) any foreign currency contract,
(3) any nonequity option, and
(4) any dealer equity option.

This provision was added to the Code by Economic Recovery Tax Act of 1981, Pub. L. 97-34, sec. 503(a), 95 Stat. 327. The definitions of these terms set out in section 1256(b) as amplified by the applicable committee reports[6] demonstrate that section 1256 contracts refer to financial transactions which take place on domestic exchanges or in the interbank market in the United States. The concern which Congress sought to avoid by enacting section 108 was to preclude the Internal Revenue Service from attacking straddle transactions of a taxpayer trading for his own account through the domestic investment banking or securities dealer facilities used for customers. There is no difficulty distinguishing transactions such as those here involved where the commodities dealer taxpayer uses trading facilities and dealers doing business in a foreign country.

In my opinion, a commodities dealer during this period of time who chose for his own account to trade in a foreign market simply placed those transactions outside the scope of section 108. It is on this basis that I would hold for respondent in this case.

WILLIAMS, *J.*, agrees with this concurring opinion.

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WELLS, *J.*, concurring: I agree with the majority opinion, but Judge Whitaker raises an additional ground with which I also agree. Judge Whitaker concludes that because the transactions on the London Metals Exchange would have been in violation of the rules of domestic exchanges in the United States, the presumption of section 108 does not apply to shield petitioner's trades. As an alternative ground for a

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[6] S. Rept. 97-144, at 158 (1981), 1981-2 C.B. 475; H. Rept. 97-215 (Conf.), at 258 (1981), 1981-2 C.B. 512.

holding for respondent in the instant case, I agree with Judge Whitaker's conclusion.

I also would like to address other comments made by Judge Whitaker with which I disagree. Judge Whitaker states that the "majority opinion simply writes section 108 off the books." With that I do not agree. The majority opinion interprets Congress' intent to be that section 108[1] does not serve to shelter from scrutiny transactions which were fictitious, prearranged, or otherwise in violation of the rules of the exchange. Dealers' transactions which are not fictitious, are not prearranged, and are in accordance with the rules of the exchange still are fully protected by section 108, i.e., such transactions per se are deemed to be entered into in the course of a trade or business and losses thereon are allowed. See H. Rept. 99-426 (Conf.), at 911 (1985), 1986-3 C.B. (Vol. 2) 911. Judge Whitaker seems to suggest that transactions by dealers which are devoid of economic substance are to be protected from disallowance by section 108. Congress surely did not intend such a result. The House report's reference to fictitious and prearranged transactions bears out such a conclusion. Congress may not have used the buzz words "economic substance," but what are transactions which are either prearranged or fictitious other than transactions devoid of economic substance?

Judge Whitaker's interpretation of the word "prearranged" is too narrow. He would limit its use to the description of a transaction that is illusory because it is fictitious, i.e., did not take place or only took place in the papers drawn up to take advantage of the tax benefits. He apparently would not use the word "prearranged" to describe a transaction which may have actually taken place in the marketplace, but which was entered into from the outset in such a way as to be designed to lack any real economic significance. I would subscribe to the broader view of the interpretation of the word "prearranged."[2] Transactions that are fictitious and transactions that are prearranged are both illusory transactions. By using the word "prearranged" in the

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[1] All references to "section 108" are to sec. 108 of the Deficit Reduction Act of 1984 as amended by the Tax Reform Act of 1986.

[2] Any other interpretation would render superfluous the language in the House report, "fictitious, prearranged."

House report, I believe Congress intended that we should scrutinize illusory transactions of both types.

The purpose of section 108 is to eliminate the requirement that commodities dealers prove a subjective profit motive, as might otherwise be required by section 165(c) of the Internal Revenue Code. Section 108 is not a carte blanche grant to commodities dealers of tax benefits for illusory transactions.[3] It is clear that Congress did not intend to single out commodities dealers for special treatment for transactions which lack economic substance. The economic substance test was in existence prior to the enactment of section 108,[4] and Congress easily could have provided that transactions of commodities dealers need not have economic substance if Congress had so intended.

STERRETT, CHABOT, PARKER, HAMBLEN, COHEN, JACOBS, WRIGHT, and PARR, *JJ.*, agree with this concurring opinion.

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[3] As we noted in *Cherin v. Commissioner*, 89 T.C. 986, 992 (1987) (Court-reviewed), the existence of a profit motive simply does not preclude a finding that a transaction lacks economic substance. Certainly, the fact that a taxpayer is in a trade or business (as sec. 108 deems commodity dealers to be) does not preclude the taxpayer's transactions from being subject to a test for economic substance.

[4] See, e.g., *Frank Lyon Co. v. Commissioner*, 435 U.S. 561, 583-584 (1978).

**Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630 (Section 108)**

**Sec. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.**

(a) GENERAL RULE. – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions-

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT. - For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

(c) NET LOSS ALLOWED WHETHER OR NOT TRANSACTION ENTERED INTO FOR PROFIT. - If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. - Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. - For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALER. - For purposes of this section, the term "commodities dealer" has the meaning given to such term by section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle).

(g) REGULATED FUTURES CONTRACTS. - For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. - Subsection (b) shall not apply to any syndicate (as defined in section 1256(e)(3)(B) of the Internal Revenue Code of 1954).

**Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817 (Section 1808(d))**

(d) SECTION 108. - Section 108 of the Tax Reform Act of 1984 is amended-

(1) by striking out "if such position is part of a transaction entered into for profit" and inserting in lieu thereof "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business",

(2) by striking out subsection (b) and inserting in lieu thereof the following:

"(b) LOSS INCURRED IN A TRADE OR BUSINESS. - For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.",

(3) by striking out the heading for subsection (c) and inserting in lieu thereof the following:

"(c) NET LOSS ALLOWED.-",

(4) by striking out subsection (f) and inserting in lieu thereof the following:

"(f) COMMODITIES DEALER. - For purposes of this section, the term 'commodities dealer' means any taxpayer who-

"(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

"(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of-

"(A) 1 or more individuals described in paragraph (1), and

"(B) 1 or more members of the families (as so defined) of such individuals.", and

(4) by striking out subsection (h) and inserting in lieu thereof the following:

"(h) SYNDICATES. - For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade of business."

**IN THE UNITED STATES COURT OF APPEALS**
**FOR THE NINTH CIRCUIT**

DAVID COOK,

*Appellant*

v.

COMMISSIONER OF INTERNAL REVENUE,

*Appellee*

No. 89-79136

## MOTION TO PUBLISH OPINION

The Commissioner of Internal Revenue Service, appellee herein, by his counsel, respectfully moves that this Court publish its opinion in the above-entitled case, which was issued as a "not for publication" opinion on April 22, 1991. In support of this motion, the Government states as follows:

1. The issue in this federal income tax case is whether Section 108(b) of the Tax Reform Act of 1984, as amended, applies to commodity transactions that are economic shams. This Court held that Section 108(b) did not apply to transactions that are economic shams and, therefore, concluded that the appellant was not entitled to deduct the purported commodity losses he incurred in London option transactions that concededly were devoid of economic substance.

2. The issue presented in this case is of continuing administrative importance to the Government. The identical issue is now pending in three consolidated cases before the Third Circuit: *Lerman* v. *Commissioner*, Nos. 90-1813 and 90-1835; 90-1814, 90-1815,, *Fraites* v. *Commissioner*, Nos. 90-1814 and 90-1836; and *Massey* v. *Commissioner*, 90-1815 and 90-1837 (oral argument scheduled for June 7, 1991). In addition, the identical issue is presented in eight cases pending before the Second Circuit: *Gardner* v. *Commissioner*, Nos. 90-4140, 90-4142, 90-4186, 90-4188; *Kazi* v. *Commissioner*, Nos. 90-4152, 90-4154, 91-4038; *Cademartori* v. *Commissioner*, Nos. 90-4148, 90-4150, 91-4026; *Horn* v. *Commissioner*, Nos. 90-4141, 90-4143; *Clark* v. *Commissioner*, Nos. 90-4144, 90-4146; *Falk* v.

*Commissioner*, Nos. 90-4156, 90-4158, 90-4160, 90-4162, 90-4164, 90-4166; *Sterling* v. *Commissioner*, Nos. 90-4168, 90-4170, 90-4174, 90-4176, 90-4178, 90-4180; and *Gutman* v. *Commissioner*, Nos. 90-4172, 90-4182.

3. Moreover, the identical issue is likely to arise in future litigation. Indeed, we are informed by the Internal Revenue Service that there are currently at least 4,282 cases pending before the Tax Court where the Commissioner is urging that the straddle transactions at issue lacked economic substance, and that as many as ten percent of those cases present the issue decided by this Court in the above-entitled case. Venue for appeals from these cases is likely to lie in every circuit court of appeals, including this circuit.

It is therefore, respectfully requested that this motion be granted and that the opinion in this case be published.

/s/

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Dated: This 6th day of May 1991.